Forms of Capital

Capital Research Partners & Co. (CRP) is a corporate finance boutique that advises middle market companies on the development and implementation of financial strategies. To serve our clients better, provide guidance and help navigating the financial strategy process, CRP launched its knowledge center. A data base containing descriptive overviews, case studies, discussion papers and more.

The following provides an overview of different forms of capital a business might choose for funding.

Senior Debt

Senior debt is usually provided by banks and other financial institutions. Holders of this form of financing have the highest claim on a company's assets. That is, in a liquidation event, senior creditors are paid in full first, before lenders holding subordinated notes. Because of the minimal risk that accompanies this block of the capital structure, senior lenders loan money at lower rates relative to more junior tiers. Within the senior debt class, there are different types of debt with different levels of relative seniority.

Line of credit

Nearly all organizations will make use of a line of credit provided by a bank or a financial institution. Which is usually secured by current assets or inventory and is typically the first to be repaid. Business lines of credit give access to a specific amount of money and only require repayments and incur interest if used. These lines of credit are often revolving, which means no reapplication is required once the balance is paid down.

Term loans

Bank term loans, which provide a lump sum of money to be paid back over a certain period of time, are a great form of debt to consider as they are relatively cheap and low risk. However, bank loans can be hard for businesses to secure. In order to qualify for a bank loan, business owners need strong personal and business credit, a large asset base, a detailed business plan, and solid industry experience. Small local or regional banks are more likely to be flexible regarding structuring of such loans.

Asset-Based Loans

Asset-based loans are, as their names suggest, loans provided by banks against the value of a company's assets. Relevant assets include: accounts receivables, inventory, and even fixed items like equipment and physical buildings. Typically, banks will be willing to lend 50-85% of the value of the agreed-upon assets. Next to equipment-based term loans, other ABLs include invoice factoring, purchase order finance or project finance.

Small Business Administration (SBA) Loan

For businesses that do not qualify for a traditional bank loan, the SBA, a government entity, may be able to help bridge the gap. The SBA particularly guarantees traditional bank loans, between 50-85% of the amount loaned, to lower lender risk and reduce interest rates on loans of up to $5 million. However, these loans have a reputation of being overly bureaucratic and for business owners who seek capital quick, the turn-around times and legwork for an SBA loan are often prohibitive. But with the right guidance the process can run smoothly.

Second Lien

Second lien debt has pledged collateral but a lower claim on it, second to, senior obligations. Meaning that, in a forced liquidation, a second lien may receive proceeds from the sale of the assets pledged to secure the loan, but only after senior debt holders have been paid. Due to the secondary claim on pledged collateral, second liens carry more risk for lenders than senior loans. As a result of the elevated risk, these loans usually have higher borrowing rates and more stringent processes for approval.

Telephone: (203) 454-0355

200 Connecticut Ave., 5th Floor, Norwalk, CT 06854

Learn more by visiting: www.crpco.com

References include:

- Axial
- Investopedia

Subordinated Debt

Subordinated debt is a class of loans that have less seniority with regard to claims on a company's assets, which makes subordinated debt more risky than senior debt. However, subordinated debt also comes with commensurately higher returns, usually in the form of higher interest payments.

Unsecured Business Loans

Unsecured business loans provide companies with financing without the need to pledge hard collateral. These loans are often used to cover gaps on a short-term basis or provide working capital to businesses who don't qualify for traditional bank financing. They can also be used in conjunction with bank financing as subordinated debt. Though costs can be higher than other alternatives, these loans can come in handy to fix a cash flow crunch or any other immediate need.

Mezzanine Capital

Mezzanine debt is a class of subordinated debt that blends equity and debt features. Mezzanine capital can dilute equity ownership, and is usually paid out at maturity, which allows business owners to direct cash flow into growing the business. Mezzanine capital, which is usually unsecured, receives liquidation after senior and second lien capital. Mezzanine capital might be used by a company that cannot secure as much money as it wants from traditional lenders. However, they come at a higher interest rate than traditional debt and usually have warrants attached – giving the lender the right to purchase equity at some point in the future at a defined strike price. Other forms of debt often used by mezzanine debt providers are payment-in-kind (PIK) notes. In essence, PIK notes allow for deferment of interest and principal payments by paying debt in kind, meaning adding more debt to the outstanding loan balance.

Convertible Debt

A form of mezzanine debt, convertible debt combines debt and equity features. Convertible bonds are the most common type of this hybrid financing, and usually take the form of bonds that can be converted to equity. The conversion can only happen at certain points in the firm's life, the equity amount is usually predetermined, and the act of converting is almost always up to the discretion of the debt holder.

Preferred Equity

Preferred equity is a class of financing representing ownership interest in a company. Unlike fixed income assets (e.g., debt), equity is a variable return asset. However, preferred equity has both debt and equity characteristics in the form of fixed dividends (debt) and future earnings potential (equity), giving the holder upside and downside exposure. Its claims on a company's assets and profits are less senior than those of debt holders but more senior than those of common stock holders. Generally, preferred equity obligates management to pay its holders a predetermined dividend before paying dividends to common shareholders. However, preferred equity typically comes without voting rights.

Convertible Equity

Convertible equity, another class of hybrid financing, usually takes the form of convertible preferred shares. Preferred shares are preferred equity that can be converted to common equity. Like convertible debt, convertible preferred shares convert into common shares at a predetermined fixed rate, and the decision to convert is typically at the owner's discretion. Importantly, the value of a firm's convertible preferred shares is usually dependent on the market performance of its common shares.

Common Equity

Common equity is a class of financing representing ownership interest in a company. Common equity is the junior-most block of the capital structure and therefore represents ownership in and business after all other obligations have been paid off. It comes with the highest risk and the highest potential returns of any tier in the capital structure.

Telephone: (203) 454-0355
200 Connecticut Ave., 5th Floor, Norwalk, CT 06854
Learn more by visiting: www.crpco.com

References include:

- Axial
- Investopedia